IABG | Illinois Asset Building Group
Building financially strong families and communities

ALTERNATIVE SMALL DOLLAR LOANS IN ILLINOIS:

Creating sound financial products through regulation and innovation

November 2009

www.illinoisassetbuilding.org

ALTERNATIVE SMALL DOLLAR LOANS IN ILLINOIS:
Creating sound financial products through regulation and innovation

In addition to regulations curbing predatory features of payday loans, financial institutions, regulators and community-based organizations must join forces to develop alternative small dollar loan products to meet the growing demand, protect customers from predatory products and expand the menu of quality products offered by banks and credit unions.

Short term, small dollar loans are often a temporary necessity for many consumers trying to make ends meet. Unfortunately, the current market is primarily limited to payday loans. In Illinois, nearly 1.2 million payday loans were issued between 2006 and 2008.[1] The mechanism for providing small dollar loans continues to be debated. Payday lenders claim that they provide a needed product and service to those underserved by other mainstream financial institutions. Consumer advocates, however, contend that payday loan products are predatory and should be regulated. Alternative small dollar loans products and other innovative mechanisms for meeting consumer demand must be explored.

Current Landscape of Payday Lending

The majority of small dollar loan products currently available to consumers in Illinois and across the country are payday loans. Payday loans are small cash advances, usually of $500 or less, which are targeted toward low-income and working consumers as one-time, emergency cash solutions. Payday loan businesses operate outside of the mainstream financial sector, often relying on a network of retail storefronts, where customers can enter a store, provide minimal personal information, and leave with enough cash to meet their immediate financial needs. Underwriting is based on information from a borrower's previous pay stub. Payday loans are collateralized against a postdated check or automatic debit authorization, which covers the principal and interest borrowed; the loans often require borrowers to have a checking account. Because payday lenders operate with very little underwriting, they explain their high interest rates and onerous payment structures as necessary to assure they operate a profitable business model. Common features of a payday loan, which often work concomitantly to cause problems for a borrower, include:

- Limited underwriting: Loans granted regardless of a consumers' ability to pay
- Sum of digits (Rule of 78ths) interest calculation: Loan interest rate structure assures interest is paid before the principle, integrating a prepayment penalty into the loan. As such, there is no incentive to pay off the loan early.
- Unequal, non-amortized payments: Lenders structure loan payment plans to include balloon payments where the last payment of the term is much higher than previous payments, often so high it is beyond the borrower's means to pay.

[1] Illinois Department of Financial and Professional Regulation. "Illinois Payday Loan Reform Act: Three Year Report." March 2009, http://www.idfpr.com/dfi/CCD/3YearPLRAReportDFI.pdf

- Rollover/refinancing options: In the face of the final balloon payment and borrower's inability to pay, a lender encourages a borrower to rollover, or refinance, the final payment, delaying the large final payment, but extending the loan term.
- High interest rates: As the loan is rolled over, again and again, the triple digit APR, which was not daunting in terms of real dollars on a short term loan, grows exponentially as the loan term keeps getting extended.

There has been enormous growth in the payday loan industry in recent years. In the three years between 2000 and 2003, national sales volumes quadrupled from $10 billion in 2000 to $40 billion in 2003.[2] Researchers put the total costs to consumers for using a payday loan at $4.2 billion annually.[3] According to the Illinois Department of Financial and Professional Regulation (IDFPR), there are 403 licensed payday lenders operating under the Payday Loan Reform Act in Illinois in 2009.[4] IDFPR found that during the three-year period between February 2006 to December 2008, 1,194,582 payday loans were taken out by 204,205 consumers in Illinois—an average of 5.9 loans per consumer at an average annual percentage rate (APR) of 341%.[5] While this data clearly illustrates demand, the absence of alternative products and concerns about predatory lending must be explored further.

Payday Loan Reform Efforts

Given the size of the payday loan industry and the need for increased consumer protections, both federal and state governments have begun to address the issue and explore regulatory changes. However, many loopholes exist within the current regulatory framework resulting in the industry staying two steps ahead of corresponding regulations. In Illinois, for example, the Illinois General Assembly passed the Payday Loan Reform Act (PLRA) in 2005 which created an interest rate cap (400% APR) for loans with terms of less than 120 days. Many payday lenders responded to these regulations by extending their loan terms beyond 120 days.[6] Another way lenders get around regulations, such as rate caps set on annual percentage rate, is to add transaction and other fees to increase their profit. Rollover policies and opportunities to take out multiple loans at one time also work to the benefit of the lenders at the expense of the consumer.

---

[2] See generally, http://www.responsiblelending.org/payday-lending/tools-resources/payday-lending-basics.html.

[3] King, Uriah, Leslie Parrish and Ozlem Tanik. "Financial Quicksand." Center for Responsible Lending. November 30, 2006. http://www.responsiblelending.org/payday-lending/research-analysis/rr012exec-Financial_Quicksand-1106.pdf

[4] Data verified from IDFPR website's payday lending licensee search: http://www.idfpr.com/dfi/LicenseeSearch/frmSearchLicensees.asp

[5] Illinois Department of Financial and Professional Regulation. "Illinois Payday Loan Reform Act: Three Year Report." March 2009, http://www.idfpr.com/dfi/CCD/3YearPLRAReportDFI.pdf. It is important to note that this data only includes those loans regulated under the Payday Loan Reform Act of 2005 – defined as loans less than 120 days in length. There is no information for loans over 120 days. See discussion of the regulatory landscape later in this brief for more information on such loans in Illinois.

[6] Feltner, Thomas and Sarah Duda. "The Illinois Payday Loan Loophole." Woodstock Institute, April 2008. Evidence suggests at a growing number of new small dollar loans are operating outside the PLRA. The roughly 30% decrease in the number of loans offered under PRLA between February 2006 and December 2008 is an indication of this shift toward loans with longer terms—over 120 days, thus outside the existing regulatory scheme. Illinois Department of Financial and Professional Regulation. March 2009. "Illinois Payday Loan Reform Act: Three Year Report." http://www.idfpr.com/dfi/CCD/3YearPLRAReportDFI.pdf

Efforts currently underway to end these practices through legislation include the following regulations:

- Establish reasonable rate charges at no more than 99% APR, including acquisition charges, handling charges, and refinancing fees;
- Limit borrowers to one small consumer installment loan at a time;
- Fully amortize loans, prohibiting balloon payments and the use of the "Rule of 78ths" as a method for interest calculation;
- Limit the number of times a payday loan is rolled over to no more than three times in 45 days;
- Limit prepayment penalties;
- Connect payment schedule to borrower's ability to pay by prohibiting monthly payments which exceed 10% of borrower's gross monthly income; and
- Mandate a 14-day "cooling off" period before borrowers can access another loan.

Achieving the proper reform of the payday loan industry will take time and is likely an ongoing endeavor. The simultaneous creation of alternate small dollar loan products is essential to create additional options for consumers.

Alternative Small Dollar Loan Efforts

Consumer advocates, financial institutions and financial regulators have begun working together to develop responsible, alternative small dollar loan products that meet consumers' needs and protect them from usurious lending practices. Rather than ignoring a market that some consumers may need, small dollar loans can be structured to provide responsible lending through a mutually beneficial product for lenders and borrowers. The following three examples highlight some of the innovative strategies currently underway and point to lessons learned for further expansion.

1. FDIC's Small Dollar Loan Pilot

In an effort to help banks create responsible small dollar loan programs as an alternative to high cost products such as payday loans, the Federal Deposit Insurance Corporation (FDIC) began a two-year pilot program in February 2008. Thirty-one banks in diverse geographic areas, with assets from $26 million to $11 billion, volunteered to participate. The program aims to assess the business practices of the banks in developing and offering profitable small dollar loan programs alongside other mainstream services.

The FDIC developed guidelines for financial institutions participating in the pilot, including:[7]

- Loan amounts of up to $1,000;[8]
- Amortization periods longer than a single pay cycle and up to 36 months for closed-end credit, or minimum payments that reduce principal (i.e., do not result in negative amortization) for open-end credit;
- Annual percentage rates below 36 percent;
- No prepayment penalties;

---

[7] Burhouse, Susan, Rae-Ann Miller, and Aileen G. Sampson. "The FDIC's Small Dollar Loan Pilot Program." Federal Deposit Insurance Corporation. FDIC Quarterly, Vol. 3, No. 2, 2009.

[8] Although the FDIC originally suggested providing loans up to $1,000, the pilot has included loans up to $2,500.

- Origination and/or maintenance fees limited to the amount necessary to cover actual costs; and
- An automatic savings component.[9]

The FDIC is compiling research from the pilot to measure the impact and effectiveness on banks' profitability and long-term customer relations. In the first year of the program, over 16,000 loans were made in 446 bank offices across 26 states, for an aggregate principle balance of $18.5 million.[10] The total amount of loans charged off in the first year was $187,378, or 3.4 percent of loans originated during the first year of the pilot.[11] Banks noted that job losses and other economic problems in their market areas led to increased delinquencies across loan categories and to a reduction in the pool of acceptable borrowers. Common factors that were cited for operating successful loan programs included: strong senior management and board support; an engaged and empowered "champion" in charge of the program; proximity to large consumer populations with demand for small-dollar loans; and, in rural markets, limited competition.

2. Small Dollar Loan Pool

The development of small dollar loan-loss reserve pools from which to capitalize alternative small dollar loan products is another mechanism for addressing this alternative credit need. A small dollar loan pool is a communal approach to offering small dollar loans, relying on a network of financial institutions and CBOs to meet the same consumer need and help to insure an institution's investments. The current model of a small dollar loan pool involves financial institutions providing the initial required funding to a community organization, which then leverages their existing relationships within the market to provide administrative and disbursement services. A collaborative approach to a loan loss reserve pool helps diversify the risk associated with the program.

The FDIC and grants from six financial institutions and one credit union provided Neighborhood Housing Services of Baltimore (NHS - Baltimore) with funding for their small dollar loan pool pilot. NHS - Baltimore made 39 loans between August and October 2009. The majority of these 12-month term loans are $1000, though some have been as small as $500. All of the loans have a competitive APR of 7.99%. A typical consumer in this pilot is an African-American woman between 40-50 years old who has filed for bankruptcy in the past but currently holds a bank account and plans to "catch up" on bills with the loan. Joan Lok, Community Affairs Specialist with the FDIC in Baltimore, stated that while financial institutions contributing to the pool were originally skeptical of the program, many have come to embrace and support the pilot's success.[12] The program aims to earn enough capital from interest to be self-sustaining. The FDIC's Alliance for Economic Inclusion and financial institutions are developing similar alternative small dollar loan pool pilots in Kansas City and Seattle.

3. Innovative Financial Institutions

---

[9] Haralson, Lyn. As explained in "Fringe Banking and Payday Loan Alternatives." Presentation at the National Community Tax Coalition's Annual Meeting. May 2008. Some community credit unions have developed an alternative repayment structure for their alternative small dollar loans. Instead of simply paying off their principal and interest of the loan, the consumer agrees to save an additional amount of money, which is collected in conjunction with their loan repayment. This feature helps consumers work towards self-sufficiency and avoid dependency on small dollar loans.

[10] Burhouse, Susan, Rae-Ann Miller, and Aileen G. Sampson. "An Introduction to the FDIC Small Dollar Loan Pilot Program." Federal Deposit Insurance Corporation. FDIC Quarterly, Vol. 2, No. 3, 2008.

[11] Burhouse, Susan, Rae-Ann Miller, and Aileen G. Sampson. "The FDIC's Small Dollar Loan Pilot Program." Federal Deposit Insurance Corporation. FDIC Quarterly, Vol. 3, No. 2, 2009.

[12] Lok, Joan. Telephone conversation with the author. 14 October 2009.

Bank and credit unions have also begun developing their own alternative small dollar loan programs. In 2002, North Side Community Federal Credit Union (North Side CFCU), recognizing the preponderance of predatory payday lenders in its community and the impact high interest debt had on its members, decided to develop its Payday Alternative Loan (PAL) program. Loans in the PAL program are $500, repaid during a six-month term, and have an annual percentage rate of 16.5%. If a first time borrower has a credit score below 600, he or she is required to attend a free financial education workshop on understanding credit and avoiding money traps and to meet with a financial counselor one-on-one to prepare a personal budget. In the past seven years, North Side CFCU has made over 5,000 PALs disbursing over $2.5 million in PAL loans, saving community residents over $3 million in fees and interest from traditional payday loans.

In July 2008, North Side CFCU launched its newest alternative loan product, the "Step-Up" loan, a payday alternative loan of $1000 available to members that have paid off at least five PALs. No credit check is required and borrowers can pay back the loan in six months or one year. Since the launch of Step-Up, North Side has made 527 loans for a total of $527,000. Ed Jacob, North Side CFCU's Manager states, "Our goal isn't to be just a cheaper payday lender. We want to give people a path that will help them reach their financial goals. We want them to think longer term, and go beyond needing a $500 loan."

<u>Potential Benefits of Small Dollar Loans for Financial Institutions</u>

Mainstream financial institutions can benefit from alternative small dollar lending by serving as the arbiter of sound financial practices for low- and moderate-income clients and profiting in a responsible way from current demand for such a product.

<u>New customer base</u> - Because the demand for small dollar loans clearly exists, financial institutions that offer products with lower interest rates than payday loans will attract new customers. Through such loans, banks and credit unions can build the financial skills and knowledge of their customers so they can graduate to more sophisticated financial products.[13] More than half of the banks in the FDIC's Small Dollar Loan Pilot program reported that customers graduated to other bank services after using a small dollar loan product.[14]

Although there is not enough data to measure the profitability of these products yet, many banks see these loan products as the cornerstone of longer-term relationships and goodwill with customers in their community. Most pilot banks open deposit accounts for customers who successfully used a small dollar loan product; however, some banks transitioned customers into more sophisticated products. One participating bank found that auto loans were a "next step" in building the lending relations with small-dollar loan customers who successfully pay off their loan.[15]

<u>Image improvement</u> - Development of an alternative small dollar loan program can help mainstream financial institutions improve their image among consumers and the public. From articles in newspapers to television reports, the current public perception of

---

[13] Wilson, Bart J., David W. Findlay, James W. Meehan, Charissa P. Wellford, and Karl Schurter. "An Experimental Analysis of the Demand for Payday Loans." Available at SSRN: http://ssrn.com/abstract=1083796.

[14] Burhouse, Susan, Rae-Ann Miller, and Aileen G. Sampson. "An Introduction to the FDIC Small Dollar Loan Pilot Program." Federal Deposit Insurance Corporation. FDIC Quarterly, Vol. 2, No. 3, 2008.

[15] Ibid.

mainstream financial institutions—particularly large banks—is negative.[16,17,18] Participation in initiatives to develop alternative small dollar loans can help re-brand banks and other mainstream financial institutions to develop a positive image in the current economic situation. As Luis Ubiñas, President of the Ford Foundation, stated in June 2009, "The economic downturn has tarnished banks brands; offering innovations and providing new opportunities to non-traditional customers can help repair the damage done to the banking industry brand."[19]

Leverage advantage in the market - Banks and credit unions have two inherent advantages over the payday loan industry in successfully offering small dollar loan programs – infrastructure and relationships.

Banks' and credit unions' existing infrastructure minimizes operational costs. While payday loan stores must spend capital on space, staff, advertising and more, banks and credit unions already have qualified staff, a large network of physical facilities, and functioning collection processes. Banks and credit unions can also easily advertise through bank statements and existing marketing materials; they have the infrastructure needed to offer small dollar loans within their existing menu of diverse products, such as revolving lines of credit, a significant improvement in meeting consumer needs.

Banks and credit unions also have the advantage of an existing relationship with a borrower. Such a relationship will allow them to help determine the type of loan best suited for a borrower, as well as streamline the underwriting process - a necessary step if banks and credit unions wish to compete with the present payday loan industry.[20] This underwriting process will also help banks and credit unions mitigate delinquency risks. Research from a pilot small dollar loan program in six sites conducted by the Woodstock Institute found that borrowers who belonged to a financial institution for one year or more reported much lower delinquency rates.[21] Clients can also be required to establish direct debt/ automatic deduction from their accounts, assuring financial institution that these loans will be repaid through automatic repayment. In return, customers will remain loyal to the bank or credit union for additional loans or other products; over three-quarters of payday loan consumers in Illinois patronized the same storefront location for additional credit products.[22] The banks' or credit unions' relationship and history with the borrower can facilitate a repayment modification, if necessary.

CRA credit - The Federal Financial Institutions Examination Council recognizes that small dollar loans meet an important credit need of underserved communities and low and moderate-income borrowers. By offering these types of loans or supporting the development of a small dollar loan pilot project, banks can earn a positive Community

---

[16] "At Rescued Banks, Perks Keep Rolling." Tomoeh Murakami Tse. The Washington Post. October 20, 2009. http://www.washingtonpost.com/wp-dyn/content/article/2009/10/19/AR2009101903546.html?hpid=topnews

[17] "Editorial: Where's the money?" The Philadelphia Inquirer. October 4, 2009. http://www.philly.com/inquirer/currents/20091004_Editorial__Where_s_the_money_.html

[18] "Poll: Frustration Growing Over Bailouts." CBSNews Online. March 16, 2009. http://www.cbsnews.com/stories/2009/03/16/opinion/polls/main4870196.shtml

[19] Benjamin, Blair. "Children's Youth Savings: Opening Plenary." CFED blog June 15, 2009. Retrieved October 14, 2009. http://cfed.org/childrens_youth_savings/2009/06/opening-plenary.html

[20] Ibid.

[21] Williams, Marva. "Cooperative Credit: How Community Development Credit Unions are Meeting the Need for Affordable, Short-Term Credit." Woodstock Institute. May 2007. www.woodstockinst.org.

[22] Illinois Department of Financial and Professional Regulation. "Illinois Payday Loan Reform Act: Three Year Report." March 2009, http://www.idfpr.com/dfi/CCD/3YearPLRAReportDFI.pdf

Reinvestment Act (CRA) rating. Such a loan product allows borrowers to avoid entrapping, high cost credit and serves the purpose and mission of the CRA.

These potential benefits should be explored further to expand the small dollar lending field beyond payday loans.

Recommendations

While loans may be more commonly associated with larger forms of wealth accumulation, they are also important for individuals and families struggling to get by. When financial emergencies arise, small dollar, short-term loans are a necessary tool for self-sufficiency. Unfortunately, Illinois consumers too often choose payday loans as their form of small dollar, short-term credit because few other options exist. Rather than serving as a helpful bridge across difficult financial times, features of the payday loans slide working families into deeper financial trouble.

Recognizing the need for alternative small dollar loans must be coupled with regulation of the industry. Borrowers and lenders do not enter into lending contracts on equal footing, in either financial understanding or bargaining power.[23] Regulation must aim to narrow this divide and protect consumers from predatory practices and their own behavioral faults.[24] This regulation will not only help support the development of sound products, but will help mainstream financial institutions remain on the "consumer-friendly" side of this debate, as supporters of alternative products.

1. Improve regulation of the small dollar loan industry

Regulators at the state and federal level play an important role in developing alternative small dollar loans and assuring proper consumer protections. The following are recommendations that state and federal government offices and elected officials should follow to support access to responsible credit for Illinois' families and communities:

- Supporting the development of a small dollar lending pool;
- Advocating in support of efforts to pass responsible regulations on unregulated payday installment loans, both at the state and federal level, such as those developed by the Monsignor Egan Campaign for Payday Loan Reform;
- Providing additional deposits from the Illinois State Treasurer's Office to credit unions and banks that offer alternative small dollar loans;
- Encouraging responsible alternative small dollar loans through the *Bank On Illinois* campaign; and
- Developing partnerships with alternative small dollar lenders—such as credit unions—to decrease government employee usage of payday lenders.

2. Expand opportunities through product development and innovation

In order to meet a recognized consumer need and provide a beneficial community service, financial institutions must begin offering or expanding small dollar credit programs to low to moderate income borrowers. As demonstrated by the existing examples, these programs can be profitable across a variety of measures.

---

[23] Saunders, Margot and Alys Cohen. "Federal Regulation of Consumer Credit: The Cause or the Cure for Predatory Lending?" Harvard University, Joint Center for Housing Studies, March 2004.

[24] Barr, Michael S., Sendhil Mullainathan, and Eldar Shafir. "Behaviorally Informed Financial Services Regulation." New America Foundation, October 2008.

- Community organizations, consumer advocates, regulatory agencies, and especially financial institutions each have an important role to play in expanding the market of small dollar loan products.
- Lending institutions should structure their programs to encourage saving among borrowers, supporting the development of important financial skills and fostering a closer relationship between participants and the lending financial institution while decreasing the borrower's assessed risk and need for small dollar loans.
- Additional pilots to test the effectiveness of small dollar loan pools should be established in new areas. Such pilots can be replicated in Chicago and other cities in Illinois. A small dollar loan pilot, supported by the FDIC, the Federal Reserve, state banking associations, the Illinois State Treasurer, community based organizations, and municipal governments, can lay the necessary groundwork for a self-sustaining alternative small dollar loan program, replicable throughout the state. Lessons from such a pilot's evolution and growth would help mainstream financial institutions create and develop their alternative small dollar loan programs.

The combination of adequate regulation and innovation will help create new opportunities for the development of sound financial products that meet the ongoing financial needs of low- and moderate-income consumers.

Illinois Asset Building Group:

The Illinois Asset Building Group (IABG) is a diverse statewide coalition invested in building the stability and strength of Illinois communities through increased asset ownership and asset protection. Made up of community leaders, service providers, researchers, advocates, financial institutions, and business leaders, IABG seeks to expand asset building opportunities in Illinois through effective policy and system changes with a specific focus on individuals, families and communities that are disenfranchised from the financial mainstream, including communities of color, people with low-incomes and their communities.

Co-Chairs:

Heartland Alliance for Human Needs & Human Rights

Sargent Shriver National Center on Poverty Law

For more information, go to www.illinoisassetbuilding.org or contact Chris Giangreco at (312) 870-4939 or cgiangreco@heartlandalliance.org